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No. 86-578

IN THE

# Supreme Court of the United States

LOUIS L. PHILLIPS AND L. L. PHILLIPS CHARITIES, INC.,

*Petitioners,*

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., AND BEN M. SIRIANNI,

*Respondents.*

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## JOINT BRIEF FOR RESPONDENTS

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## QUESTION PRESENTED

Whether predispute arbitration agreements between a customer and a securities broker-dealer must be enforced as to claims arising under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), and Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240 10b-5 (1975).[1]

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[1]Purusant to Rule 28.1 of the Court, petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated states that it is a subsidiary of Merrill Lynch & Co., Inc., a publicly-held corporation whose shares are traded on, among others, the New York Stock Exchange. Subsidiaries of Merrill Lynch, Pierce, Fenner & Smith Incorporated that are not wholly-owned are: Merrill Lynch & Co., Canada, Ltd., Merrill Lynch Canada Incorporated/Incorporee, Merrill Lynch Life Agency Inc. (Ohio), Merrill Lynch Life Agency Inc. (Oklahoma), Merrill Lynch Life Agency Ltd. (Mississippi), Merrill Lynch-Nomura Management Company, Inc., and ML Life Agency Inc. Affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated that are not wholly-owned by Merrill Lynch & Co., Inc. are ISU Companies, Inc., Merrill Lynch Bank & Trust Co., Merrill Lynch International Bank Limited, Mership Nominees Limited, Michigan Mart Properties Corp., Peaback Properties, Inc., Iran Financial Services Company, S.S.K., Merrill Lynch Asset Management Limited, Merrill Lynch (Australia) Pty Limited, Merrill Lynch, Pierce, Fenner & Smith (Brokers & Dealers) Limited, Merrill Lynch, Pierce, Fenner & Smith Limited, Royal Securities Corporation (Canada) Limited, Paluel-Marmont Merrill Lynch S.A., Merrill Lynch Philippines, Inc., Merrill Lynch, Pierce, Fenner & Smith Belge S.A., Merrill Lynch, Pierce, Fenner & Smith (Middle East) S.A.L., Merrill Lynch, Pierce, Fenner & Smith S.A., Merrill Lynch S.A.L., Merrill Lynch Pierce, Fenner & Smith (Taiwan) Ltd., Property Protection Associates & Co., Merrill Lynch — Sun Hung Kai (Overseas Securities) Company Limited, Sun Hung Kai - Merrill Lynch Commodities Limited, Merrill Lynch Representacoes Ltda., Merrill Lynch Realty Commercial Services of Georgia, Inc., Hammill-Quinlan, Inc., Merrill Lynch Realty North Bay Inc., Merrill Lynch Realty/North Los Angeles, Inc., Merrill Lynch Realty/Boomhower, Inc., Merrill Lynch Realty/Burnet, Inc., Merrill Lynch Realty Carll Burr, Inc., Merrill Lynch Realty/Cousins, Inc., Merrill Lynch Santa Barbara Inc., Merrill Lynch Realty/Jack Matthews, Inc., Merrill Lynch Realty/-Katella, Inc., Merrill Lynch Realty/MCK, Inc., Merrill Lynch Realty/-Richard Jowdy, Inc., Merrill Lynch Realty/Robedeaux, Inc., Merrill Lynch Realty/Tom Fannin Inc., ML/Rodgers & Cummings Insurance, Inc.

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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## JOINT BRIEF FOR RESPONDENTS

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Respondents Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") and Ben M. Sirianni ("Sirianni") respectfully respond to the petition for a writ of certiorari filed by petitioners Louis L. Phillips ("Phillips") and L. L. Phillips Charities Inc. ("Charities") seeking review of the decision of the United States Court of Appeals for the Eighth Circuit in this case.

Respondents believe that the Eighth Circuit correctly decided the question presented in the Petition. Recognizing, however, that on October 6, 1986, this Court granted a writ of certiorari in *Shearson/American Express, Inc. v. McMahon*, No. 86-46, on the question presented by the instant petition, respondents do not oppose a grant of the writ in

this case. If this Court grants the writ, the Eighth Circuit's decision should be affirmed.[2]

## STATEMENT OF THE CASE

The factual background supplied in petitioners' Statement of the Case is incomplete. The facts are more fully set forth in the Eighth Circuit's Opinion. Pet. App. A-2 to A-7. Respondents submit the following specific facts that relate to the issues raised by the petition.

In 1978, petitioners Phillips and Charities opened accounts with respondent Merrill Lynch through respondent Sirianni, a broker in Merrill Lynch's office in Eau Claire, Wisconsin.[3] In their contracts, the parties voluntarily agreed to submit to arbitration any disputes arising from their relationship.

On July 6, 1981, Phillips filed a Complaint in the Federal District Court for the District of Minnesota. The Complaint alleged that various misrepresentations, omissions and unauthorized trading violated Section 10(b) of the Securities Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C. § 78j(b), Section 12(2) of the Securities Act of 1933 ("the 1933 Act"), and various state-law duties, both statutory and common-law. Merrill Lynch answered the Complaint, denying the allegations and raising various affirmative defenses.

On June 5, 1984, in light of this Court's decision in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), Merrill

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[2]Respondent Merrill Lynch currently has pending before this Court a petition for a writ of certiorari from a decision of the Third Circuit that is in direct conflict with the Eighth Circuit's decision in the case at bar. *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 749 F.2d 1197 (3rd Cir. 1986), *petition for cert. pending*, No. 86-487.

[3]For convenience, this response will use "Phillips" to include both petitioners, and "Merrill Lynch" to indicate both respondents, except where otherwise indicated explicitly or by context.

Lynch moved the district court for an order compelling arbitration of the state securities-law and state common-law claims, and the district court granted the motion.[4] Pursuant to the district court's order and the parties' agreement, the state-law claims were arbitrated under the rules of the National Association of Securities Dealers ("the NASD") in May, 1985. The arbitrators rendered a decision awarding petitioners a total of $1,126,700.00. On Phillips' motion and Merrill Lynch's cross-motion, the district court confirmed the arbitration award and entered judgment thereon. Subsequently, the district Court also awarded prejudgment interest on the arbitration award for the period from the date of the award to entry of judgment. The judgment and interest have been paid in full.

On March 27,1985, following this Court's decision in *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985), but prior to the arbitration on Phillips' state-law claims, Merrill Lynch moved the district court for an order compelling arbitration of the claim arising under Section 10(b) of the 1934 Act. On April 19, 1985, the district court denied this motion. Merrill Lynch then requested that Phillips conditionally submit the Section 10(b) claims to the same panel of arbitrators as was deciding the state-law claims, with the award to be enforceable as to Section 10(b) claims only if the district court's decision was reversed on appeal. Phillips declined this request. Meanwhile, Merrill Lynch

[4]The Minnesota Blue Sky Law contains a non-waiver provision similar to that contained in Section 14 of the 1933 Act, 15 U.S.C. § 77n and Section 27 of the 1934 Act, 15 U.S.C. § 78aa. Minn. Stat. 80A.23 subd. 10 (1982). Prior to *Southland*, the Minnesota Supreme Court had held that predispute arbitration agreements were unenforceable as to claims arising under Minn. Stat. § 80A. *Kiehne v. Purdy*, 309 N.W.2d 60 (Minn. 1981). In light of *Southland*, and subsequent to the district court's decision in the case at bar, the Minnesota Supreme Court expressly overruled *Kiehne. Fairview Cemetery Association v. Eckberg*, 385 N.W.2d 812, 817-18 (Minn. 1986).

had appealed the district court's refusal to compel arbitration of the 1934 Act claims. The Eighth Circuit heard argument on December 11, 1985, and handed down its decision on July 9, 1986, reversing the court below. In remanding, the Eighth Circuit noted that the arbitration award on the state-law claims in the interim may preclude further recovery by petitioners, but it left examination of that matter to the district court on remand. By stipulation of the parties, the district court has taken no further action, pending this Court's decision on the instant petition.

## RESPONSE TO THE PETITION

Respondents again stress their belief that the Eighth Circuit decided this question correctly. Nevertheless, because this Court has already granted a similar writ in *Shearson/American Express, Inc. v. McMahon*, No. 86-46, and because the question presented in this case is one of national importance, respondents do not oppose the petition and ask this Court to affirm the Eighth Circuit's decision.

## I

## THE EIGHTH CIRCUIT IS THE ONLY APPELLATE COURT THAT HAS CORRECTLY APPLIED THIS COURT'S PRECEDENT.

In the proceeding below, the Eighth Circuit held that predispute arbitration agreements are enforceable as to claims arising under Section 10(b) of the 1934 Act. In explaining its holding, the Eighth Circuit openly acknowledged that its decision conflicted with recent decisions of the Second[5] and Eleventh[6] Circuits; subsequent to the

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[5]*McMahon v. Shearson/American Express, Inc.*, 788 F. 2d 94 (2d Cir. 1986), *cert. granted*, No. 86-46 (Oct. 6, 1986); see also *Kidder Peabody & Co. v. Intre Sport, Ltd.*, No. 86-40.

[6]*Miller v. Drexel Burnham Lambert, Inc.*, 791 F. 2d 850 (11th Cir. 1986).

Eighth Circuit's decision, the Third, Fifth, and Ninth Circuits have come into conflict with the Eighth Circuit's holding.[7] In *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. at 215 n.1, this Court noted that the enforceability of predispute arbitration agreements in this context is an open question. The Eighth Circuit is the one appellate court to have answered that question by implementing the views set forth in Justice White's concurrence. *Id.* at 224-225.

The Eighth Circuit began with the central assumption, repeatedly and emphatically upheld by this Court, that the Federal Arbitration Act mandates enforcement of arbitration agreements. Pet. App. at A-7 to A-9; *see also Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. at 218, 220-21. The Eighth Circuit then observed that this Court had held in *Wilko* that the 1933 Act had created an implied exception to the Arbitration Act. The Eighth Circuit noted that its own task was to determine whether the 1934 Act had implicitly created such an exception.

The Eighth Circuit then examined the arguments that had led this Court in *Wilko* to find an implicit partial repeal of the Arbitration Act. The *Wilko* Court had noted the broad jurisdictional provisions of the 1933 Act; the Eighth Circuit noted that the 1934 Act had more limited provisions. The *Wilko* Court had viewed section 12(2) as a "special right" significantly different from the common law; the Eighth Circuit noted that the section 10(b) right is no different from the common-law fraud law in any relevant respect and that it is an implied right of action, not a "special" right. The

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[7]Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 749 F.2d 1197 (3d Cir. 1986), *petition for cert. pending*, No. 86-487; King v. Drexel Burnham Lambert, Inc., 796 F.2d 59 (5th Cir. 1986), *petition for cert. pending*, No. 86-282; Conover v. Dean Witter Reynolds, Inc., 794 F.2d 520 (9th Cir. 1986), *petition for cert. pending*, No. 86-321.

Eighth Circuit therefore concluded that "Congress has not evinced an intention to preclude the waiver of judicial remedies" for section 10(b) claims. Pet. App. at A-22.

In derogation of the Eighth Circuit's opinion, petitioners offer two arguments from post-enactment history, which they incorrectly state that the Eighth Circuit "disregarded." *First,* they argue that the Eighth Circuit's decision conflicted with an SEC regulation purporting to ban predispute arbitration agreements as deceptive practices. The Eighth Circuit correctly noted that the regulation is based on a faulty premise—that such agreements are unenforceable as to claims arising under the 1934 Act. Having rejected the premise, the Eighth Circuit found the conclusion unsupported.

*Second,* petitioners argue that certain remarks in a 1975 congressional committee report amount to congressional ratification of *Wilko* and its extension to the 1934 Act. The Eighth Circuit rejected this argument, citing Justice Scalia's opinion in *Hirschey v. F.E.R.C.*, 777 F.2d 1, 7-8 (D.C. Cir. 1985) (Scalia, J., concurring). More recently, the Eleventh Circuit, although disagreeing with the Eighth Circuit's ultimate conclusion, noted that the very remarks quoted by petitioners are completly ambiguous and do not support the argument here. *Wolfe v. E.F. Hutton & Co.*, 800 F.2d 1032, 1037 (11th Cir. 1986) (en banc). The Eleventh Circuit also noted the further argument, raised by petitioners here, that in adopting the 1975 amendments to the 1934 Act, Congress failed to explicitly state that predispute arbitration agreements are enforceable. But even the Eleventh Circuit recognized that "an inference from congressional silence is of somewhat limited value . . ." *Id.* at 1038.

In short, the Eighth Circiut began with decisional framework that this Court used in *Wilko*, and it determined that

neither the factors determinative in *Wilko* nor the additional arguments that petitioners raised support an implied repeal of the Federal Arbitration Act. This decision correctly applies the *Wilko* holding and the dictum in *Byrd* and *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 513-14 (1974). Respondents urge this Court to affirm the Eighth Circuit's decision.

## II

## THE *PHILLIPS* RECORD PRESENTS A UNIQUE OPPORTUNITY BECAUSE IT CONTAINS THE PROCEEDINGS OF A COMPLETED ARBITRATION.

### A

The *Phillips* records contains what no other case now pending before this Court contains: the transcript of a completed arbitration. Indeed, the existence of an arbitration transcript is itself rare because, consistent with arbitration's interest in inexpensive and streamlined proceedings, transcripts are not usually made.[8]

In *Wilko v. Swan*, 346 U.S. 427, 435-36 (1953), this Court cited the less formal procedures of arbitration as a significant reason in justifying its decision not to enforce the Federal Arbitration Act in the context of a claim arising under Section 12(2) of the 1933 Act. In pointed contrast, Justice Frankfurter, joined in his dissent by Justice Minton,

[8]The NASD Arbitration Rules provide that no record of the proceedings need be kept, but if a party requests that a record be kept, then a verbatim record *must* be kept. NASD Code of Arbitration Procedure § 37, NASD Manual (CCH) ¶ 3737 (1984). The costs of transcription are paid by the party or parties requesting the record. *Id.* In this case, Merrill Lynch requested that a record be made; Merrill Lynch bore the full cost of transcription. The transcript consists of six volumes, one for each day of the proceedings. This transcript is cited hereinafter as "Arb. Tr."

noted that "[t]here is nothing in the record before us, nor in the facts of which we can take judicial notice, to indicate that the arbitral system as practiced in the City of New York, and as enforceable under the supervisory authority of the District Court for the Southern District of New York, would not afford the plaintiff the rights to which he is entitled." *Id.* at 439.

Justice Frankfurter's remarks are especially appropos to this case, for Phillips received ample protection—and vindication—of his substantive rights. Pursuant to the agreement between Phillips and Merrill Lynch, the parties' dispute was submitted to arbitration before the NASD.[9] The NASD arbitration director nominated a five-member panel of arbitrators. The NASD rules permit each party at least one peremptory challenge and an unlimited number of challenges for cause,[10] although in this case neither party used any challenges since all of the arbitrators were acceptable to the parties. As required by the NASD Rules, a majority of the panel were "public" representatives; only two members of the panel were from the securities industry.[11] The chair-

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[9]The agreements provide that Phillips would have five days after receipt of a demand for arbitration to designate the exchange before which he wished the arbitration to be conducted, although he did not have to agree to submit to arbitration in order to exercise this right of designation. In the event that Phillips did not so designate within five days, Merrill Lynch was permitted to designate. Phillips did not designate a forum within the permitted time, so Merrill Lynch designated NASD.

[10]NASD Code of Arbitration Procedures § 22, NASD Manual (CCR) ¶ 3722 (1984). A copy of the NASD Code of Arbitration Procedures has been made available to the Court in the Supplemental Lodging of Amici Curiae in Support of a Petition for a Writ of Certiorari in *Shearson/American Express, Inc. v. McMahon*, No. 86-46. The Supplemental Lodging also contains copies of the American Stock Exchange, Inc. Arbitration Rules and the New York Stock Exchange. Inc. Arbitration Rules. The Amicus brief filed with the Supplemental Lodging contains the Uniform Code of Arbitration as Appendix A.

[11]*Id.* ¶ 19, NASD Manual (CCH) ¶ 3719(a). Under the terms of this rule, a public customer (but not the broker-dealer) is permitted to waive this requirement and insist that the panel contain at least a majority from the securities industry.

man of the panel was a former judge on the Illinois Court of Appeals, who has stepped down from that court at the end of 1984. Another member was a professor of law at DePaul University in Chicago. Two other members were lawyers in private practice, and one of them actually had been a floor trader at the Chicago Board Options Exchange, Inc. The fifth member was a director of compliance for a broker-dealer.

The arbitration hearing lasted six days. Prior to the hearing, the parties had exchanged exhibits and had agreed upon a schedule for witnesses. The panel accepted briefiing on various legal issues, including, for example, the choice-of-law issue. The panel disposed of several preliminary matters, much as an Article III court would do, and then heard opening statements. There followed several days of testimony, and the parties were permitted to make objections; in at least one instance, the panel permitted a voir dire of a witness prior to determining whether to admit the testimony. Arb. Tr. at 520-24. Both parties were permitted to and did present expert testimony. At the end of the hearing, each side presented closing arguments. The hearing was then concluded. In the words of petitioners' counsel, the NASD hearing had given petitioners "an opportunity to be heard, a good opportunity and equal, too." Arb. Tr. at 1187.

Ultimately petitioners prevailed. They did not receive the full damages that they claimed, but they did receive a sizeable award of $1.2 million. If making a transcript of arbitration proceedings is atypical, the award in petitioners' favor certainly is not. For the five-year period 1980-85, 52% of the public-customer cases actually decided in the public customer's favor.[12] For 1985 alone, the figure was

[12]Fifth Report of the Securities Industry Conference on Arbitration, Statistical Report (April 1986) (Exhibit A). This report does not include statistics for the American Arbitration Association.

55%.[13] In other words, the facts amply support the theory: predispute arbitration agreements do not deprive customers of any substantive rights—they merely provide a forum for their vindication.

Thus, arbitration does not disadvantage securities plaintiffs as a class; they retain their substantive protections against wrongdoing by broker-dealers. Similarly, the much larger class of securities *customers*, of which securities *plaintiffs* are just a small subclass,[14] retain the deterrent effect of these substantive protections in their own transactions.

Respondents believe that the Arbitration Act is mandatory and that the 1934 Act in no way implicitly limited that mandate. Therefore, the procedures that a securities plaintiff obtains in arbitration should be of little consequence. Nevertheless, the *Wilko* Court considered the procedures important in construing the 1933 Act, and this Court may wish to examine the procedures available in contemporary arbitration. To the extent that the type of procedures available to securities plaintiffs in 1986 may be significant to this Court, the *Phillips* record presents the ideal opportunity to examine those procedures not only in theory but in practice as well.

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[13] *Id.*

[14] The securities industry executes millions of transactions for its customers every year, but the number of legal actions brought against broker-dealers is relatively small. For example in fiscal year 1985, there were 3,266 newly filed actions in the federal courts under both securities and commodities statutes. *See* Annual Report of the Director of the Administrative Office of the United States Courts, Table 19 (1985) (statistics for 7/84-6/85). This statistic does not include 1933 Act claims filed in state court under that statute's concurrent-jurisdiction provisions, but it *does* include all 1934 Act claims, which must be filed exclusively in federal court.

B

Examination of the *Phillips* record might be useful to the Court in another way. If predispute arbitration agreements are enforceable in this context, then in the future, 1934 Act claims and state-law claims will be submitted and heard together. If on the other hand, 1934 Act claims cannot be arbitrated pursuant to predispute agreements, then there will necessarily be two procedings when a plaintiff asserts both state and federal claims. This possibility in turn raises the problem of the preclusive effect, if any, to be accorded to an arbitration award on state-law claims in subsequent proceedings on related federal claims. Indeed, in its opinion remanding this matter to the district court, the Eighth Circuit noted that "[t]he arbitration award may well bar further proceedings by Phillips on the basis of issue preclusion, full satisfaction of claims or for other reasons."[15] Pet. App. at A-28 to A-29.

In *Byrd* this Court observed that the potential for preclusion problems was not a reason for failing to enforce the Arbitration Act. *Dean Witter Reynolds Inc. v. Byrd,* 470 U.S. at 221-223. Here the Court faces a different question: in construing a federal statute and reconciling potentially conflicting Federal statutes, may the Court consider the practical and public policy consequences of its decision? Clearly the Court may do so. *See e.g., Walton v. Cotton,* 60

[15]By stipulation of the parties, the district court has taken no action pending this Court's decision on the petition. See *supra* at p. 4. Preclusion quite probably will bar further proceedings on the 1934 Act claims if this Court affirms the Eighth Circuit's decision, for the abitrators decided essentially the same issues as would be raised in proceedings on the 1934 Act claims. Even if this Court reverses the Eighth Circuit, preclusion might still come into play, either because the petitioners proceeded to arbitration of their state-law claims knowing of the potential preclusion problems, or because they sought and obtained judicial enforcement of the abitration award.

U.S. (19 How.) 355, 358 (1857). In this instance, the Court might rightly consider two public policy considerations: the burgeoning federal caseload, and the difficulties entailed in devising new preclusion rules. These two problems will be exacerbated if this Court refuses to enforce predispute agreements, and so before reaching such a decision, the Court might wish to consider the proceedings that might be given preclusive effect.

This Court could largely eliminate the problem of preclusive effect by holding predispute arbitration agreements enforceable.[16] In reaching this highly practical result, the Court may find it useful to examine the *Phillips* arbitration and the type of proceeding in which securities claims would be resolved.

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[16]The issue would still exist as to 1933 Act claims, which under *Wilko* cannot be abitrated pursuant to predispute agreements. There will also be a temporary problem as to those cases in which arbitration has occurred prior to this Court's resolution of the enforceability question.

## CONCLUSION

For the reasons stated in this Brief, if the Petition for Writ of Certiorari in this case should be granted, the Eighth Circuit's decision should be affirmed.

Dated: November 6, 1986.

Respectfully submitted,

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